Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SF:TL-N-4052-01
PKWebb

VIA INTER-OFFICE MAIL

date:

to: Mel Chinen, Appeals Officer, Northern California Appeals, San Francisco

from: Paul K. Webb, Attorney, CC:LM:CTM:SF

subject: [redacted]
Section 166(a)(2) Advisory

DISCLOSURE STATEMENT

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Issues

You requested our advice regarding the following three issues:

1. For purposes of claiming a partial bad debt deduction under I.R.C. § 166(a)(2), what does the phrase "charged off within the taxable year" mean?

2. Does claiming a partial bad debt on a filed Federal tax return, in and of itself, constitute a charge off within the meaning of I.R.C. § 166(a)(2)?

3. What is the reason for the phrase "by the close of the taxable year, or as soon as practicable thereafter," as stated in Treasury Regulation § 1.593-5(b), and how does that statement comport with the language of I.R.C. § 166(a)(2)?

Summary Answers

1. For a taxpayer which maintains formal books and records, a "charge off," within the meaning of Section 166(a)(2), requires a physical notation within the taxpayer's books reflecting that the portion of debt determined to be worthless is no longer counted as an asset. The "within the taxable year" requirement of Section 166(a)(2) is less settled. The courts will likely apply the analysis of the former bad debt code section, which contained the same relevant language. Using that analytical framework, the courts will examine the steps the taxpayer took within the actual tax year to determine worthlessness of the debt, and, if sufficient steps were taken, the taxpayer will then be allowed a reasonable time after the close of the taxable year to make its final book entries, including charging off the specific debt. This "reasonable time" would not extend beyond the close of the taxpayer's books for the relevant tax year.

2. No. The few cases which have found a partial bad debt charge off to exist based upon a tax return notation involved taxpayers which did not maintain formal books and records. Such cases would not be relevant to your present case, given that the taxpayer maintains formal books and records.

3. The statutory scheme of Section 593 requires a taxpayer to determine a "reasonable" amount to contribute to its bad debt reserve fund. Under one prior formula, the amount was limited to a percentage of the taxpayer's taxable income (percentage of taxable income method), which could not have been known until its Federal tax return was prepared. The treasury regulation which allows for a debt reserve book entry to be made by the end of the taxable year or as soon as practicable thereafter, became effective while the percentage of taxable income method was still viable. Thus, the regulation necessarily provided that the taxpayer was allowed time beyond the end of the taxable year to make the book entry to its bad debt reserve fund. Additionally, the "reasonable" amount to contribute to a bad debt reserve fund is best determined after the end of the taxable year, when the taxpayer computes its final year-end numbers. Neither of these reasons are applicable to deductions for charging off specific debts under Section 166(a)(2). Thus, there is no reason to allow taxpayers utilizing Section 166 the additional time (as soon as practicable after the end of the taxable year) to make book entries, which is provided for in Treasury Regulation § 1.593-5(b).

Facts

[redacted] ("taxpayer") merged with [redacted] on [redacted]. Prior to the merger, taxpayer had filed its Federal tax returns utilizing a calendar year. As a result of the merger, taxpayer filed a short period final Federal tax return encompassing the period from [redacted] through [redacted].

Taxpayer claimed a bad debt deduction of $[redacted] on its final Federal tax return. Presently at issue in this memorandum is $[redacted] of that total bad debt deduction, which was disallowed in accordance with Notice of Proposed Adjustment ("NPA") #179. The subject bad debt deduction represented [redacted] separate loans and was reported as a Schedule M-1 reconciliation adjustment on the taxpayer's return. The subject bad debt deduction was apparently limited to partially worthless, rather than wholly worthless, debts.

The Service disallowed the subject bad debt deduction because of (1) lack of substantiation, and (2) the taxpayer's failure to charge off the loans within the taxable year. For this second position, the Service relies upon the plain language of I.R.C. § 166(a)(2), which provides that the Secretary may allow a deduction for partially worthless debts in an amount not in excess of the part *charged off within the taxable year* (emphasis added). The Secretary determined that several of the documents used to compose the $[redacted] deduction were dated not only after the close of the taxable year, but after the taxpayer's closing trial balance had been prepared on [redacted]. This factual conclusion is supported by one of the taxpayer's internal memorandums, which is attached to NPA #179 as Exhibit 1.

The taxpayer claims that all of the bad debt charge offs were made based upon facts known as of [redacted], the merger date with [redacted] and last date of the short taxable year. Furthermore, the taxpayer claims that the charge offs were determined by [redacted] (see Appeals protest), and that said charge offs were reflected in its final financial statements, dated no later than [redacted]. The taxpayer additionally states that the net charged off loan balances were reflected as the beginning balances on [redacted]'s post-merger balance sheet. Finally, without additional factual statements or legal analysis, the taxpayer asserts that for all accounting and regulatory purposes the charge offs were treated as being removed from the its books as of [redacted].

The taxpayer relies upon Chief Counsel advice provided in

Technical Advice Memorandum ("Tech. Advice") 9248048 for the proposition that it is entitled to the claimed deductions despite the fact that the charge off book entries were effectuated later than the end of its short taxable year. The taxpayer's argument will be addressed at the conclusion of this memorandum.

Analysis

I. For purposes of claiming a partial bad debt deduction under I.R.C. § 166(a)(2), what does the phrase "charged off within the taxable year" mean?

Deductions for worthless and partially worthless debts are governed by I.R.C. § 166. That section provides a deduction for any debt which becomes worthless within the taxable year. I.R.C. § 166(a)(1). As for partially worthless debts, that section provides that "When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction." I.R.C. § 166(a)(2).

The rules for establishing worthlessness of a debt are set forth in Treasury Regulation § 1.166-2. In summary, when determining whether a debt is worthless in whole or in part, the district director will consider all pertinent evidence, including the value of collateral, if any, securing the debt and the financial condition of the debtor. Treas. Reg. § 1.166-2. Additional provisions in the Treasury Regulation address the bankruptcy of a debtor and the presumption of worthlessness when a bank subject to regulatory authority is ordered to charge off a debt, or, where the bank utilizes the operating policies established by such authority and upon the first regulatory audit by the authority it confirms in writing that such a charge off would have been ordered. Treas. Reg. § 1.166-2(d).

As is evident from the plain language of Section 166, there are at least two distinctions between how wholly worthless and partially worthless debts are treated under Section 166. *Compare* I.R.C. § 166(a)(1) *with* (2). First, unlike deductions for worthless debts, Congress has granted the Service additional discretion to decide whether or not to allow a deduction for partially worthless debts. I.R.C. § 166(a)(2)("... the Secretary may allow such debt ....."). The courts review such cases for arbitrary and capricious determinations by the Secretary. RLC Indus. Co. v. Commissioner, 58 F.3d 413 (9th Cir. 1995)(pointing out that Section 166(a)(2) is the only operative Internal Revenue Code section granting the Secretary such discretion) *citing* Wilson Bros. v. Commissioner, 124 F.2d 606, 609 (9th Cir. 1941). This discretion applies to both the determination that a debt is partially worthless and that said worthless portion has been charged off. *See* Treas. Reg. § 1.166-3(a)(2)(iii)("Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off."). No such additional discretion is granted to the Secretary when reviewing deductions for completely worthless debts.

The second statutory distinction between worthless and partially worthless debts involves the requirement that partially worthless debts be "charged off within the taxable year." *Compare* I.R.C. § 166(a)(1) *with* (2). There is no statutory prerequisite of charging off a debt in order to claim a deduction for a wholly worthless debt. *See* I.R.C. § 166(a)(1). A deduction for a wholly worthless debt requires no more action than claiming it upon a Federal tax return or claim for refund in the year the debt became worthless. Tech. Advice 9522003 (1994); 2 B. Bittker & L. Lokken, Federal Tax'n of Income, Estates and Gifts, Para. 33.4 (1990 ed.). A partially worthless debt, however, must be *charged off* within the taxable year in order to be considered by the Secretary for deductibility. *See* I.R.C. § 166(a)(2)(emphasis added).

The nature of the first question you pose calls for a two-part analysis. First, the term "charged off" must be defined. Second, it must be determined how courts apply the "within the taxable year" language of the statute. We have attempted to breakdown this section of the memorandum accordingly. However, a close reading of the cited cases demonstrates that the courts often address the two requirements as one, i.e., was there a charge off within the taxable year?

<u>A. What is a Charge Off?</u>

Section 166 and the treasury regulations thereunder do not define the term "charged off." However, substantial authority exists suggesting that, in order to charge off a debt, a taxpayer must take some action to remove the worthless portion of the asset from its books as an indication that the debt is actually worthless. *See* Private Letter Ruling ("PLR") 9338044 (1993) *citing* <u>Fairless v. Commissioner</u>, 67 F.2d 475, 478 (6th Cir. 1933)(affirming decision of Unites States Board of Tax Appeals and disallowing deductions for bad debts where taxpayer had not made a charge off on its books). In <u>Fairless</u>, *supra*, the court stated: "It was clearly the purpose of the Congress to condition allowance of a deduction for bad debts upon the perpetuation of evidence that they were ascertained to be worthless within the taxable year, and upon some specific act of the taxpayer clearly indicating their abandonment as assets." In another partially worthless debt case, the Tax Court has stated: "... an effective charge off has been made if the entries relied upon have effectually been eliminated from the amount of the debt, or that part which is worthless, from the book assets of the taxpayer." Brandtjen & Kluge v. Commissioner, 34 T.C. 416, 441 (1960) *acq.* 1960-2 C.B. 4.[1]

The Fairless, *supra*, case involved a factual scenario remotely similar to the present case. The petitioners in that case were all stockholders in Union Finance Co., a corporation which by corporate action taken in 1922 transferred all of its assets to the Metropolitan Securities Co. in January, 1923. On its 1922 tax return, the Union Finance Co. claimed a bad debt deduction, despite the fact that it had not charged off the debts on its books with formal entries by the close of that taxable year. The petitioners argued that they had satisfied the charge off requirement by providing a list of accounts receivable to the officers of Metropolitan Securities Co., during the acquisition negotiations, which listed the subject items as worthless debts. Thereafter, they listed these same amounts on their tax return. The court rejected this argument, finding that the notification to the prospective purchaser was not the equivalent of the specific act (charge off) required as a condition precedent to claiming a bad debt deduction. The court found that the petitioners had failed to charge off the debts within the taxable year, as was required by the clear and specific statute.

The Ninth Circuit Court of Appeal cited the Fairless, *supra*, case favorably in Santa Monica Mountain Park Co., Ltd. v. United States, 99 F.2d 450 (9th Cir. 1938). In that case, the Ninth Circuit stated:

> The basic idea underlying the requirement of a charge off during the taxable year is 'to prevent taxpayers from adopting the patently inconsistent position of deducting debts as worthless and at the same time

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[1]You may note that many of the cases cited within this memorandum are several decades old. Historically, once United States savings and loan institutions became subject to taxation, most of these entities claimed bad debt reserve account deductions, instead of claiming specific bad debt deductions. However, after December 31, 1995, only "small banks," as defined by the statute, are allowed to utilize the bad debt reserve method for deducting bad debts. Thus, more bank related Section 166(a) debt cases may develop post-1996. To the extent that these older cases are cited herein, they are applying former statutes with identical relevant language to Section 166(a)(2).

> considering the debts as assets. In other words, if the taxpayer considers debts as uncollectible for income tax purpose, they must be worthless in all respects and he cannot use these uncollectible debts as assets in his balance sheet; if he wishes to deduct the debts he must have effectually eliminated them from his books.' Paul & Mertens, Law of Federal Income Taxation (1934), Vol. 3, § 28.26, p. 418.

Santa Monica Mountain Park Co., Ltd., *supra*.

The Tax Court favorably cited the Fairless, *supra*, case as recently as 1980. *See* Southern Pac. Transp. Co. v. Commissioner, 75 T.C. 497 (1980). In Southern Pac. Transp. Co., *supra*, the Tax Court stated:

> To effect a 'charge off,' a taxpayer was required to take some affirmative action to show that the debt was no longer considered an asset. Merely writing off the amount of the debt from the relevant account was insufficient if the taxpayer's treatment of the outstanding obligation was otherwise incompatible with the ascertainment of worthlessness.

The Tax Court concluded in that case that since the petitioning taxpayer had continued to look to the debtor for payment under the obligation, it was "doubtful" that the debts had been charged off. Id.

In Brandtjen & Kluge, Inc. v. Commissioner, *supra*, the Tax Court was likewise faced with the issue of whether a taxpayer had actually charged off a partially worthless debt. The taxpayer, under a prior Code provision, had credited an entry to a reserve fund (a fund designed to absorb anticipated losses) rather than eliminating any amount from the book asset account. The Court found that the taxpayer had met the charge off requirements, despite the failure to eliminate the amount from the asset account, since (1) the book entries were limited to one specific indebtedness (a specific reserve in the reserve fund), and (2) the entries were intended to accomplish a charge off and were described in terms indicating a sustained loss, rather than an anticipated loss, in the one specific account. The court, however, expressed its difficulty in arriving at this conclusion. Id., *but compare* International Proprietaries, Inc. v. Commissioner, 18 T.C. 133 (1952)(taxpayer utilizing specific debt section could not rely upon reserve account notation as a charge off).

In Hamlen v. Welch, 116 F.2d 413 (1st Cir. 1940), the First Circuit Court of Appeal took a more liberal approach to analyzing the "charge off" standard and distinguished Fairless, *supra*. In late 1935, the taxpayer in Hamlen, *supra*, had recorded cash payments within his personal cash book, not as evidence of charging off debts, but as evidence of payment. Additionally, an appraisal of the properties to which the payments related was completed in November of 1935 and established a loss associated with the properties. Subsequently, in January and February of the following taxable year, the cash payment entries were recorded in the taxpayer's profit and loss account in the journal and ledger and were posted "as of" December 31, 1935. The Court of Appeal concluded that the debts were charged off within the taxable year and stated:

> Ordinary business practice necessitates the allowance of a reasonable time after the close of year for the auditing of the books and physical notation of the closing entries of profit and loss. It is not the physical act done within the year to which Congress has referred, but to the setting up of evidence as to the ascertainment of worthlessness substantially as of the date of such ascertainment and in confirmation thereof in order that such entries will effectually eliminate the amount of bad debt from the book assets of the taxpayer. ... In the instant case, the entries were made to profit and loss in January and February, 1936, as of December 31, 1935. This is enough to bring the case within the law as construed.

The Court of Appeal went on to factually distinguish Fairless, *supra*, by stating that in that case the taxpayer had failed to make any charge offs at all on its books before filing its Federal tax return and that there was no evidence of any investigation by the taxpayer in Fairless, *supra*, into the alleged worthlessness of the accounts allegedly charged off.

The Hamlen, *supra*, opinion does not specify whether the cash notations or the appraisal were the acts sufficient to constitute a "charge off." Nor does it specify whether the "charge off" was the actual notation to the books, which took place subsequent to the end of the taxable year. Rather, the court looked to all of these facts and found that together they constituted a charge off within the taxable year, as required by the statute.

The Ninth Circuit Court of Appeal cited both Fairless, *supra*, and Hamlen, *supra*, in Rogan v. Commercial Discount Co., 149 F.2d 585 (9th Cir. 1945). The Rogan, *supra*, opinion cites to and explains the facts of Hamlen, *supra*, a case which it describes as construing "the law and regulations to allow relaxation of the statutory rule only within the reasonable orbit of operations in accounting practice." The Rogan, *supra*, court interpreted the Hamlen, *supra*, opinion to have concluded that it was the appraisal in November, 1935, which ascertained worthlessness and thus allowed for the deduction. Interestingly, immediately thereafter the Rogan, *supra*, opinion states: "The absolute necessity of a strict compliance with the statute and regulations is emphasized in Fairless [supra]."

In Rubinkam v. Commissioner, 118 F.2d 148 (7th cir. 1941), the Seventh Circuit Court of Appeal addressed a claimed bad debt deduction by a taxpayer who did not maintain formal accounting books. The court in Rubinkam, *supra*, took a broad approach to defining the charge off requirement, stating:

> Congress has not provided any particular mode of charge off nor has it prescribed the mechanical process of keeping accounts. Accounts may be recorded in an elaborate set of books, or in mere memoranda, or be recorded only in the brain of the taxpayer. Therefore, anything which manifests the intent to eliminate an item from assets is sufficient to constitute a charge off. ....

The court went on to find that the taxpayer's handing of a $3,500 note to his tax return preparer and informing him to charge it off, and the return preparer's subsequent deduction on the return and notation on the note that it had been charged off, was sufficient under the statute.

The Rubinkam, *supra*, opinion is notable in that it demonstrates how a taxpayer that doesn't maintain formal books and records can charge off a debt. Since there is no statutory definition for charge off, the court took a broad approach in determining what a charge off would consist of in the context of a taxpayer with no accounting books. As the Service correctly points out in the attachment to NPA #179, the courts have held taxpayers that maintain formal books and records to a higher standard than that required in Rubinkam, *supra*.

In PLR 9338044, Chief Counsel opined as to whether a taxpayer had charged off partially worthless debts. The taxpayer had entered into loan agreements through its branch office in a foreign country. In that country, the generally accepted accounting principles required that the Ministry of Finance approve any charge off of debt and that a reserve account be established. Despite the fact that the foreign authority had not yet approved the charge off, the taxpayer had treated the debt as partially worthless in its United States accounting operations, e.g., (1) the taxpayer treated the debt as a foreclosure on its books and records and reflected it as a charge off on its U.S. Call Report filed with the Board of Governors for the Federal Reserve, (2) manually adjusted its U.S. maintained books and records reflecting the charge off, and (3) recorded the transaction as a loss on its U.S. profit and loss statement for the fiscal year end. Chief Counsel determined that these steps satisfied the charge off requirement of Section 166(a)(2), despite the fact that the debts were not yet charged off under the governing rules in the foreign entity.

In summary, although the statute and regulations do not define what a "charge off" consists of, the courts appear to require a physical notation within the taxpayer's books reflecting that the portion of debt determined to be worthless is no longer counted as an asset. *See* Fairless, *supra*, et al. Alternatively, in the event that there is a failure to remove the debt from the asset column, a charge off might be found where the books reflect the specific loss charged off in a specific debt reserve notation (so long as not otherwise treated inconsistently). *See* Brandtjen & Kluge, Inc., *supra*.

B. Defining the Phrase "Within the Taxable Year."

Unfortunately, the courts have not recently defined the "within the taxable year" language of Section 166(a)(2). Under older case law, such as Hamlen, *supra*, Mason Machine Works Co. v. Commissioner, 3 B.T.A. 745 (1926), et al., the courts interpreted the "within the taxable year" requirement of the prior bad debt statute relatively loosely. In Hamlen, *supra*, the First Circuit Court of Appeal stated:

> ... The decisions of the Board of Tax Appeals have, in the majority of cases, been specifically acquiesced in by the Commissioner; and in the light of this circumstance and the frequent repassage of the identical language in subsequent revenue acts, we believe the interpretation of the statute to be well established to include this case.
>
> *Ordinary business practice necessitates the allowance of a reasonable time after the close of the year for the auditing of the books and the physical notation of the closing entries of profit and loss. It is not the physical act done within the year to which Congress has referred, but to the setting up of evidence as to the ascertainment of worthlessness substantially as of the date of such ascertainment and in confirmation thereof in order that such entries will effectually eliminate the amount of bad debt from the book assets of the taxpayer.* ... In the instant case the entries were made to profit and loss in January or February, 1936, as of December 31, 1935. This is enough to bring the case within the law as construed.
> ....

Hamlen, *supra*, (emphasis added). If this approach is still applied today, the required analysis will involve determining the extent to which the taxpayer set up the evidence of worthlessness up to the point of ascertainment of whether or not the debt was worthless. To the extent that sufficient evidence of worthlessness was ascertained within the actual taxable year, the physical notation to the books must be done within a reasonable period from the close of the taxable year. This "reasonable period" appears to be a time frame within which the taxpayer should be able to audit its year-end books and make the final entries to its profit and loss ledger.

In summarizing the above-quoted test, in Malden Trust Co. v. Commissioner, 110 F.2d 751 (1st Cir. 1940), the First Circuit Court of Appeal stated:

> ... It may not be amiss to note, however, the frequent holdings of the Board where debts ascertained to be worthless in one year are charged off shortly after the close of that year before the books are closed, they may be deducted in the year of ascertainment. [citations omitted] ....

In framing the test in this manner, the First Circuit clarified that the closing of the taxpayer's books would constitute an outside boundary within which the taxpayer must make its charge off entries. Id.; *see also* Cammack v. United States, 113 F.2d 547 (8th Cir. 1940)(restating same), et al.

Two more recent Tax Court cases involved the "within the taxable year" standard of the statute, but did not expressly define what the term requires. Additionally, a 1983 Claims Court case addressed the phrase in the context of a unique timing issue. Although not directly on point, these cases apply the statutory language and may prove useful to your analysis.

In The Austin Co., Inc. v. Commissioner, 71 T.C. 955 (1979), the taxpayer held debt of Tobacol, a wholly owned subsidiary in the tobacco industry. In regards to that debt and pursuant to Section 166(a)(2), the taxpayer claimed a deduction of $146,477, which it had charged off during the taxable year. Upon audit of the taxpayer's return, the Service adjusted the taxpayer's Tobacol debt account, increasing it by $129,045. At trial the taxpayer sought an additional Section 166(a)(2) deduction for the $129,045 of adjusted debt. The Tax Court found for the Service, holding that since the taxpayer had not recorded that additional debt on its books at the end of the taxable year, it had not charged it off within its fiscal taxable year. As such, it had not met the requirements of Section 166(a)(2). The fact that it was impossible for the taxpayer to charge off the debt within the taxable year, since it was previously unaware of the debt, was irrelevant.

In Bender v. Commissioner, T.C. Memo. 1967-26, the Tax Court stated:

> While it has been held that a write-off physically made shortly after the taxable year may nevertheless be considered made "within the taxable year" if it is dated as of the last day of the taxable year, *cf.* Mason Machine Works Co., 3 B.T.A. 745, 750, the writeoff in this case was made not only four months after Jefferson Leather's fiscal year had closed, but was dated as of a month after the end of its fiscal year. In these circumstances, no part of the Royce Shoe indebtedness was "charged off" during the fiscal year ended November 30, 1959, and consequently no deduction for a partially worthless debt can be allowed for that year.

The Bender, *supra*, opinion could be read to hold that if a debt is charged off more than four months after the close of a taxable year it will not be deemed to have been completed within the taxable year. However, the Tax Court emphasized the fact that the taxpayer did not even date the charge off "as of" the taxable year for which it claimed the deduction, and thus the court's holding was likely based upon that ground. As such, it is unclear how helpful the Bender, *supra*, opinion will be to your analysis.

Velvet O'Donnell Corp. v. United States, 1 Cl. Ct. 683 (1983), presented an interesting, though distinguishable, partially worthless debt issue. At issue before the Claims Court was whether a loss due to the partial worthlessness of the debt of another corporation is, under consolidated return regulations, an allowable deduction on the consolidated return in the year of affiliation where the companies became affiliated after the bad debt was determined partially worthless and its charge off authorized by resolution of the taxpayer's board of directors, but before the charge off was reflected on the company's books at year's end. The heart of the issue became whether, under certain circumstances, a debt is charged off prior to the end of a taxable year, for an accrual taxpayer, or whether the charge off occurs at the end of the year when the journal entry was recorded. The court stated:

> ... Court's have not unswervingly bound themselves to the formality of recordation as evidence of the worthlessness of a bad debt, but have at times looked to the substance of the events in deciding if a write-off has occurred. In fact, our court's predecessor has held board action to be sufficient recognition of worthlessness even where there has been no deduction on the books and records at the year's end. First State Bank of Stafford, 67 Ct. Cl. 332, 335 (1929). I

> conclude that the substance of the tax event must be looked to in interpreting § 1.1502-14(d)(1), and, therefore, that the date the board declared the debt worthless, and not the date the journal entry was made is the date upon which the loss was recognized. Since this occurred prior to the affiliation of Velvet and Haaberstroh, deferral is not necessary.

The Velvet O'Donnell Corp., *supra*, case did not present the issue of whether a charge off had occurred during the taxable year. That issue had already been agreed to by the parties. The finding instead revolved around whether the board of director's action declaring the debt worthless was sufficient to constitute a charge off, or, alternatively, whether the actual book entry, taking place at a later date, was the only action which could be deemed a charge off. Id. *see also* MacGruder v. Fidelity & Deposit Co., 139 F.2d 751 (4^{th} 1944)(a formal resolution by the finance committee directing the treasurer, positively and unequivocally, to charge off the entire claim at a specified rate of $20,000 per month, along with a definite entry on taxpayer's ledger in pursuance of the direction of the finance committee and then the claim of deduction thereon in the income tax return was sufficient for charge off). The Claims Court found that the board of director's resolution regarding the debt was the event, for timing purposes, to constitute a charge off.

In summary, the "within the taxable year" requirement of Section 166(a)(2) is not precisely defined by case law. Based upon decisions applying former Section 23, the prior bad debt statute which required charge offs within the taxable year, a court would look to the extent to which the taxpayer ascertained worthlessness of the debt within the actual tax year and then, if sufficient evidence of worthlessness was ascertained within the year, the court would grant the taxpayer a reasonable time to make its final book entries after the close of that taxable year. This "reasonable time" limit has been described as "shortly after the close of the year" and "the first few months of the succeeding year as of the preceding taxable year." *See* Malden Trust Co., *supra*; Hamlen, *supra*. The Ninth Circuit Court of Appeal has described the "reasonable time" as a relaxation of the statutory rule only "within a reasonable orbit of operations in accounting practice." Rogan, *supra*. At the latest, the actual book entries must be made before the closing of the taxpayer's year-end books. *See* Malden Trust Co., *supra*; Hamlen, *supra*. Closing of the books, in this context, is likewise not well defined.

II. Does claiming a partial bad debt on a filed Federal tax return, in and of itself, constitute a charge off within the meaning of I.R.C. § 166(a)(2)?

As set forth above and in I.R.C. § 166, there is no charge off requirement for wholly worthless debts. However, a deduction for partially worthless debts is only allowable to the extent that the worthless portion of such debt is charged off within the taxable year.

Since a Federal tax return is not filed *within* the taxable year for which it applies, it cannot serve as a charge off *within* the taxable year under Section 166(a)(2). *See* I.R.C. § 166. In Fairless, *supra*, the court rejected an argument by the taxpayers that a charge off occurred when they claimed the deduction on their filed Federal tax return. The court stated: "Since deduction for bad debts may not be had unless claimed on the return, and since the return is invariably made after the close of the taxable year, to hold the claim of deduction equivalent to the required charge-off would render the statutory requirement nugatory." Fairless, *supra*.

Some cases have held that there is a different standard for taxpayers who do not maintain formal books and records, i.e., that a claim on their tax return constitutes a charge off. *See* Cammack, *surpa*, (setting forth several opinions finding a charge off when taxpayers who do not maintain formal accounting books merely stated the bad debt on their filed Federal tax return). Such opinions focus their analysis upon the taxpayer making a considered determination during the relevant tax year that a debt has become worthless. The courts consider the claim on the tax return as merely the final physical step in the charge off. However, as the taxpayer in your case does maintain formal books and records, these opinions are irrelevant to your present case.

For taxpayers that maintain formal books and records, a claimed deduction on a Federal tax return, in and of itself, would not meet the "charged off within the taxable year" requirement of Section 166(a)(2).

III. What is the reason for the phrase "by the close of the taxable year, or as soon as practicable thereafter," as stated in Treasury Regulation § 1.593-5(b), and how does that statement comport with the language of I.R.C. § 166(a)(2)?

Prior to December 31, 1995, all qualified thrift institutions were authorized by I.R.C. § 593 to claim bad debt deductions by utilizing the bad debt reserve method in lieu of the specific charge off method provided for in I.R.C. § 166(a)(2). Subsequent to December 31, 1995, all thrift institutions that are treated as large banks ([redacted]) are required to utilize the Section 166(a)(2) charge off method for claiming partially worthless bad debts, instead of the bad debt reserve method. *See* I.R.C. § 593(f).

Under Section 593, a qualifying taxpayer is allowed a deduction for amounts set aside to a bad debt reserve fund. I.R.C. § 593. The purpose of such a reserve fund is to absorb losses stemming from worthless debts. Colorado County Fed. Sav. & Loan Assoc. v. Commissioner, 36 T.C. 1167 (1961), *aff'd* 309 F.2d 751 (5th 1962). Subject to various restrictions and computations, the amount *set aside* to the reserve fund is limited to a reasonable amount to be determined by the institution. *See* I.R.C. § 593(c)(emphasis added). This set aside requirement has been interpreted to mean that the taxpayer must actually make a book entry reflecting the credit to the reserve fund in order to be entitled to the deduction. *See* Newport Fed. Sav. & Loan Assn. v. Commissioner, 259 F. Supp. 82 (1966); United-American Sav. & Loan Assn. of Pittsburgh, PA v. Commissioner, T.C. Memo. 1968-91. The book entry must be made by the close of the taxable year, or as soon as practicable thereafter. Id.; Treas. Reg. § 1.593-5(b)(1).

The logic behind the book entry requirement was aptly set forth by the Tax Court in Arcadia Savings & Loan Assoc. v. Commissioner, 34 T.C. 679 (1960):

> When a taxpayer elects to adopt the reserve method of deducting bad debts, he is allowed a reasonable addition and corresponding deduction each year even though no debts became worthless during the year. This amount, however, must be expressly set aside on the books of the company to provide a reserve for future losses. The underlying reason is that if, upon the association's liquidation, there remains a balance in the reserve account, or the reserve is invaded for other purposes, the association must pay income taxes in relation to this amount, since the amount represents deductions in prior years which never actually represented bad debts.

Thus, there is a valid income tax reason for requiring a taxpayer utilizing the reserve method to correctly book his reserve debt deductions. Said amounts may become taxable at some future point in time.

The requirement that the reserve account book entry be made by the close of the taxable year "or as soon as practicable thereafter" was established by Treasury Regulation, rather than the statute itself. Therefore, there is no legislative history from which to cull the reasoning for the "as soon as practicable thereafter" language. However, certain cases, Revenue Rulings, and Chief Counsel Tech. Advice apply the language and are therefore instructive in that regard.

In Revenue Ruling 68-410, a taxpayer established and maintained bad debt reserve accounts in accordance with Section 593. For taxable year 1966, the taxpayer secured an extension to file its Federal tax return until September 15, 1967. The taxpayer filed its return on that date, claiming the subject bad debt reserve deductions. Seven days later the taxpayer received the data necessary to make the book entries supporting the bad debt reserve deductions and made the entries accordingly. The Service determined that since the taxpayer had established that it was unable to obtain the information by an earlier date and since the book entries were made within 7 days of the return filing, the taxpayer had met the "as soon as practicable thereafter" language of the Treasury Regulation, despite the fact that the entries occurred 8 months subsequent to the close of the taxable year.

In Tech. Advice 783004, the taxpayer claimed bad debt deductions on its filed Federal tax returns but neglected to make the book entries to reserve accounts reflecting said deductions until it was audited, which was one year subsequent to the filing of the latest subject return. Chief Counsel opined that the taxpayer had failed to make the book entries by the close of the taxable year "or as soon as practicable thereafter." Id.

In Peoples Fed. Sav. & Loan Assn. v. United States, 320 F. Supp. 179 (D.S.C. 1970), the district court determined that a book entry made to the reserve account 4 1/2 months subsequent to the filing of its return was "as soon as practicable" due to the illness of the company's accountant and the pressure of his business. However, when no valid reason was shown for extending the book entry date beyond the filing of the return, courts have more strictly applied the timeliness requirement. *See* Annapolis Fed. Sav. & Loan Assoc. v. Commissioner, T.C. Memo. 1972-243. For example, in Wegport Fed. Sav. & Loan Assn. v. United States, 259 F. Supp. 82 (E.D. Ark. 1966), the district court held that the taxpayer's 2 1/2 month delay beyond the return filing in crediting its reserve account did not comply with the regulation. In Colorado County Fed. Sav. & Loan Assoc. v. Commissioner, *supra*, the Tax Court held that book entries 1 1/2 and 2 1/2 years after filing of the respective returns failed to satisfy the regulation.

In Rio Grande Bldg. & Loan Assoc. v. Commissioner, 36 T.C. 657 (1961), the Tax Court arguably made its clearest pronouncement as to the logic of the "as soon as practicable" language of Section 593. There, the court stated:

> The regulations thus recognize variations in general accounting procedures and, we believe, correctly do not establish an absolute time limit by which the entries must be made on the books. Ordinary business practices necessitate the allowance of a reasonable time after the close of the year for the auditing of the books, the physical notation of the closing entries to profit and loss, and the adjusting entries, including the entries to the various reserve accounts. While we do not intend to establish such a time limit, generally the limit should be not later than the time at which the taxpayer files its income tax return for the year involved. At that time, it is in a position to ascertain what would be a reasonable amount to add to the reserve account, and can determine what the net income is if it is a factor limiting the amount of the allowable reserve deduction.

Thus, the logic of the requirement is at least in part tied to the fact that the taxpayer determines the reasonable amount to credit to the reserve fund. Because the taxpayer is not necessarily deducting specific bad debts when it credits a reserve fund, it should be allowed to review its final year-end books before determining what would be a reasonable amount to credit to the fund.

Your request for advice inferentially addresses the logic for a distinction between the Section 166(a)(2) requirement that a "charge off" for a partially worthless debt be made *within the taxable year*, whereas, the book entry for the debt reserve fund deduction under Section 593 must be made by close of the taxable year "*or as soon as practicable thereafter.*" Treas. Reg. § 1.593-5(b). We believe the logic behind this distinctive treatment lies in the nature of the two types of deductions.

The deduction for partially worthless debts is limited to specific debts only. Treas. Reg. § 1.166-3(b). The partial bad debt deduction of Section 166 is allowable in the year that a portion of the debt becomes worthless and that portion is charged off. I.R.C. § 166(a)(2). If a taxpayer charges off what it determines to be a partially worthless debt and deducts said amount and the Service later determines that said amount was not a worthless debt in the claimed taxable year, the taxpayer may again claim the worthless portion of the debt in a subsequent year, when the debt does become worthless, limited to the amount previously charged off and the amount charged off in the subsequent year. Treas. Reg. § 1.166-3(a)(2). A taxpayer may take a deduction subsequent to the year that it becomes partially worthless, so long as it claims the deduction in the year charged off, or may subsequently deduct the entire debt at such time as the debt becomes totally worthless. Findley v. Commissioner, 25 T.C. 311, 318, 319 (1955). In determining whether a debt is partially worthless, there is no requirement that the taxpayer know its final year-end income and deductions. Rather, the focus is upon the factual question of when and to what extent a debt became worthless during the taxable year.

The reserve method of deducting bad debts under Section 593 allows taxpayers to deduct a reasonable contribution to its bad debt reserve fund, in lieu of deducting specific debts under Section 166. The determination of what constitutes a reasonable contribution to the debt reserve is best made during closure of the yearly books. *See* Rio Grande Bldg. & Loan Assoc., *supra*. Thus, taxpayers utilizing Section 593 are logically allowed to make their book entries by the close of the taxable year "or as soon as practicable thereafter." Furthermore, under the percentage of taxable income method (Section 593(b)(2)), a qualifying taxpayer was allowed a bad debt reserve deduction limited to a certain percentage of its taxable income, which, obviously could not be known until all of the books were closed and the taxpayer's tax return was calculated.[2] Thus, there was a necessary and logical reason for allowing taxpayers additional time beyond the end of the taxable year to make their final bad debt reserve book entries.

The rationale behind allowing additional time to make book entries for taxpayers utilizing the bad debt reserve method, to wit, to determine a reasonable amount to contribute and to know the contribution limit if utilizing the percentage of taxable income method, is not applicable to the Section 166 specific debt deduction scheme. There are no such compelling reasons to allow taxpayers additional time to book specific partially worthless debts (as charge offs) beyond the close of the taxable year, as is necessitated under the bad debt reserve method.

Taxpayer's Argument

Instead of relying upon cases, such as Hamlen, *supra*; Cammack v. United States, 113 F.2d 547 (8^{th} Cir. 1940); Brandtjen & Kluge, Inc., *supra*; Bakers Mut. Co-op. Assoc. v.

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[2]Subsequent to the amendment effective December 31, 1995, there is only one method available (the experience method), which is only available to small banks. I.R.C. § 593.

Commissioner, 20 BTA 593 (1930), or, Mason Machine Works v. Commissioner, 3 BTA 745 (1926), acq. 1927-1 C.B. 4, all of which seem to loosely apply the "charged off within the taxable year" language ultimately incorporated into Section 166(a)(2), the taxpayer argues that it is entitled to the subject bad debt deductions under the logic of PLR 9248048 (1992). The taxpayer's argument is unpersuasive.

PLR 9248048 involved a taxpayer bank which utilized the reserve method of accounting for bad debts, as provided for in Section 593. In [redacted] the bank's private auditor began an annual audit of the bank's [redacted] financial statements. On [redacted] a state regulatory entity began an audit of the bank's same statements. Shortly thereafter the FDIC joined the state entity in the regulatory audit. During the course of the audit, the government regulators discovered various accounting and lending problems and ultimately ordered the bank to charge off its books approximately $[redacted] of items previously recorded as assets. The bank's board of trustees authorized an addition to its loss reserve fund of $[redacted] on [redacted], and the reserve addition was entered into the books on [redacted], and back-date recorded as of [redacted]. Due to the regulatory audit, and the bank's need for a subsequent audit by a private firm, the bank did not make its final book entries necessary to charge off the ordered losses until [redacted]. On [redacted], the bank filed its Federal tax return for the period ending [redacted] which listed the amounts ordered charged off in the debt reserves schedule in accordance with Section 593.

Chief Counsel responded to the bank's PLR request with the following brief analysis. First, in lieu of the Section 166 deduction for worthless debts, a qualifying mutual savings bank is allowed a deduction under Section 593(a)(1) for a reasonable addition to its reserves for bad debts. Ordinarily, the issue of whether a debt is worthless is a question of fact. Under Treasury Regulation § 1.166-2(d), if a regulatory authority orders a bank to charge off a debt, such debt will be considered conclusively worthless during that tax year. The purpose of this regulation is so taxpayers are treated consistently by different branches of the Federal government. Thus, since the bank was ordered to charge off the subject debts, it is entitled to rely upon the conclusive presumption of worthlessness as provided in the regulation.

The taxpayer interprets PLR 9248048 to apply to its situation as follows. First, the taxpayer acknowledges that the bank in the PLR is distinguishable in that it operated under the bad debt reserve method of Section 593, whereas the taxpayer operates under the specific charge off method of Section 166. Second, the taxpayer argues that the presumption of worthlessness provision of Treasury Regulation § 1.166-2(d)(1) applies to a debt only to the extent that it is "charged off within the taxable year." *See* Treas. Reg. § 1.166-2(d)(1). The taxpayer argues that this is the same "charged off within the taxable year" requirement that is present in Treasury Regulation § 1.166-2(a)(2)(i), which is the regulation that governs partially worthless debts and is applicable to the taxpayer's claimed deduction. Third, the taxpayer points out that Chief Counsel concluded that the presumption of worthlessness applied despite the book entries being made after the close of the taxable year. The taxpayer thus concludes that Chief Counsel has determined that a charge off claimed "as of" the prior taxable year is claimed "during" the taxable year for purposes of Section 166. The taxpayer's handwritten objection states:

> "If the National Office had followed [the Service's approach in the NPA], the taxpayer in the [PLR] would not have qualified for the conclusive presumption. The charge offs would have been claimed within a reasonable period ("as soon as practicable") after the year end under § 593 but would have been subject to potential disallowance on audit."

As stated above, the taxpayer's argument is unpersuasive.

A review of the relevant code sections is necessary in order to fully comprehend Chief Counsel's analysis in PLR 9248048. This analysis, in turn, is relevant to understanding the flaw within the taxpayer's argument.

A taxpayer may deduct wholly worthless debts under Section 166(a)(1), and partially worthless debts, to the extent charged off within the taxable year, under Section 166(a)(2). Deductions under Section 166(a)(2) are often referred to as being made under the "specific charge off method."

In lieu of utilizing the specific charge off method, qualifying taxpayers (such as the bank in the PLR) may utilize the "bad debt reserve method" of Section 593. Under Section 593(a), a qualifying taxpayer is entitled to a deduction for a reasonable addition to a reserve for bad debts. Prior to December 31, 1995, there were two methods for computing the "reasonable" amount to contribute to a bad debt reserve. First, taxpayers could utilize the "experience method." I.R.C. § 593(b)(1). Section 593(b)(1) directs taxpayers utilizing the experience method to Section 585(b)(2), which sets forth a formula for computing a reserve amount. In summary, under the experience method a taxpayer computes its bad debt reserve amount on the basis of its actual experience as shown by actual losses for the current year and the 5 preceding years. The second manner for determining a reasonable bad debt reserve addition was known as the "percentage of taxable income method." I.R.C. 593(b)(2). This method is no longer available after December 31, 1995. Under the percentage of taxable income method, a taxpayer computed its bad debt reserve addition based upon its taxable income for the year. Id.

Taxpayers utilizing the bad debt reserve method need to determine worthlessness of actual debts in order to balance their reserve accounts. Additionally, under the experience method, taxpayers track the worthlessness of their debts in order to determine the reasonable addition to their bad debt reserves. *See e.g.*, Rev. Rule 92-14; Rev. Rule 79-214; Beneficial Corp. v. United States, 814 F.2d 1570 (Fed. Cir. 1987); Smith Elec. Co., Inc. v. United States, 198 Ct. Cl. 644, 461 F.2d 790 (1972); Bank of Kirksville v. United States, 943 F. Supp. 1191 (W.D. MO. 1996). As such, the test for worthlessness, set forth in Treas. Reg. § 1.166-2, becomes relevant to these determinations. Under that regulation, a determination of worthlessness is based upon a factual review of the debt, including the value of any collateral and the financial condition of the debtor.

Under Treas. Reg. § 1.166-2(d)(1), if a bank, which is subject to supervision by Federal or state authorities, charges off any debt in whole or in part in obedience to the specific orders of such authorities, then the debt shall, to the extent charged off during the taxable year, be conclusively presumed to have become worthless or partially worthless, as the case may be, during such taxable year. In summary, the regulation provides that if a bank is ordered to charge off a debt in a particular year, that debt will be presumed to be worthless, or partially worthless, in that taxable year and may be claimed as a deduction accordingly.

The policy underlying the conclusive presumption of worthlessness in Treas. Reg. § 1.166-2(d)(2) is based in consistency. By providing a conclusive presumption of worthlessness when a taxpayer bank is ordered to charge off a particular debt, the taxpayer will not later be made to face a contra position before a different Federal agency, namely the IRS. *See* Rev. Rule 80-180. The IRS has agreed to be bound by the determination of the other agency in issues of whether a particular debt has become worthless or partially worthless.

As stated above, taxpayers utilizing the bad debt reserve method must track the worthlessness of actual debts in order to balance their reserve accounts. *See* Beneficial Corp., *supra*, et al. Additionally, taxpayers must track the worthlessness of debts to compute a reasonable bad debt reserve addition when utilizing the experience method. *See* Bank of Kirksville, *supra*. Therefore, the conclusive presumption of worthlessness provided for in Treas. Reg. § 1.166-2(d)(2) is relevant to the bad debt reserve statutory scheme of Section 593. *See e.g.,* Rev. Rule 79-214.

At issue in PLR 9248048 was whether the bank could rely upon the presumption of worthlessness for a debt charged off later than the end of a taxable year but recorded as of a time within the taxable year. In concluding as it did, Chief Counsel inferentially determined that a charge off *ordered by a governing regulatory agency* and executed by a taxpayer beyond, but "as of," the end of a taxable year, qualifies for the presumption of worthlessness. This conclusion was in keeping with the policy of consistency, which is the underlying purpose of the regulation.[3] *See* PLR 9122001. To conclude otherwise would have elevated the "to the extent charged off *within* the taxable year" language over the purpose of the regulation. Thus, in the event that a regulatory agency orders a charge off that occurs after the close of a particular taxable year, and the taxpayer effectuates such charge off as of that taxable year, the conclusive presumption of worthlessness will apply and the charge off will be considered to have occurred within the taxable year, since to conclude otherwise would defeat the consistency sought by the regulation.

In the taxpayer's situation, there was no order by any regulatory agency to charge off the particular debt. Thus, the goal of consistency sought by the regulation would not apply. Therefore, the logic of the conclusions in PLR 9248048 are not applicable to the taxpayer's situation. The presumption of worthlessness and its underlying goal of cross-agency consistency is simply not present in this case. As such, the "as of" charge

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[3]"[I]f the conclusive presumption of worthlessness applies to a debt, the Service, generally, is bound by the supervisory authority's determination of worthlessness and the amount of worthlessness for purposes of bad debts. In the absence of any guidance restricting a supervisory authority's determination of the amount of worthlessness, to allow the Service to make its own determination as to the amount of worthlessness would undermine the whole purpose behind the regulation. Allowing differing amounts of worthlessness would eliminate the efforts to provide taxpayers with consistent treatment when dealing with the Service and other branches of the federal government." PLR 9122001.

off argument made by the taxpayer is unpersuasive. There is no similar overriding policy reason presented by the taxpayer which would require an accommodation of the "within the taxable year" language of Section 166.

Conclusion

Please contact attorney Paul K. Webb at (415)744-[redacted] if you have any questions regarding this memorandum. Additionally, to the extent that any statements within this memorandum raise further issues in your attempted resolution of this case, or, if you would like this office to provide a detailed opinion applying the facts of this case to the relevant law, please feel free to contact attorney Webb.

This advice is subject to 10 day post-review by the National Office of Chief Counsel. CCDM 35.3.19.4. Accordingly, we request that you do not act upon this advice until we have advised you of the National Office's comments, if any, concerning this memorandum.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

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